Manitoba Agriculture

INVENTORY TAKING - THE FIRST FIRST STEP TO A CLEAR FINANCIAL PICTURE

Information Update

DATE: March, 1989

Profits from your farm business mean a better lifestyle for you and your family. Profits mean diversification, expansion or upgraded equipment. Profits also let you plan for your retirement and for transferring your farm to the next generation.

In order to maximize your profits, you need a thorough understanding of your farm's financial picture, both past and present. The only way you can do this is by keeping accurate farm financial records.

Financial records provide a clear picture of your farm. A clear picture helps you make sound management decisions. And sound decisions mean maximum profits. One of the most important - and timely - steps in completing your financial records is taking inventory.

Here's why you must take inventory.

Cash Records

Cash records provide a good indication of cash inflows and outflows on your farm. They also provide the most flexible method for completing your income tax.

But cash records alone can show an incomplete financial picture of your farm. Because net cash income can be raised or lowered by changing the timing of cash receipts or cash payments of expenses, adjustments to cash records are necessary to show your true net farm income.

With a cash accounting system, income is only recorded when it is actually received. For example, when you receive a cheque for grain sold, it is recorded as income. If, however, you sell your grain on a deferred ticket, the income is not recorded until it is turned into cash.

Similarly, expenses are recorded in a cash system only when they are paid. For example, fertilizer which was bought and paid for in December is a cash expense in the current year. If the fertilizer was not paid for until January, it is a cash expense for the following year.

As earlier indicated, timing of cash receipts and expense payments can dramatically affect a farmer's net cash income in a year. A cash income can be transformed into a cash loss by increasing expense payments or deferring cash receipts. While this often makes economic sense for income tax, this unadjusted financial information provides an incomplete financial picture of the farm's performance in a year.

Net Farm Income

To derive an accurate picture of your farm's performance, you need to "match" the revenues generated in a year with the expenses incurred to produce those revenues. By completing this matching of revenues and expenses, you determine your farm's net farm income.

Under this "accrual" method of accounting, income is recorded when it is generated by the farm, not necessarily as it is received in cash. For example, if the farm produced $50,000 of grain in a year, this is recorded as income whether or not it is sold and converted to cash.

Similarly, expenses are recorded when they are incurred, whether or not they have been paid. For example, if fertilizer purchased for this year's crop remains unpaid at the end of December, it is still recorded as an expense. However, if fertilizer is purchased for <u>next year's crop</u>, whether or not it is paid, it is <u>not</u> considered an expense for that crop year. It represents an expense for next year because the fertilizer will be utilized in producing next year's crop.

Adjustments To Cash Income and Expenses

While a farmer could record income and expenses directly on an accrual basis, a much simpler method requires making adjustments to cash income and expenses. These adjustments require recording the beginning and end of year values for certain inventory items.

This adjustment process begins with net cash income. To this, you add changes in crops and livestock inventory, feed and farm supplies and accounts receivable. Deduct any changes in accounts payable and accrued interest. Also deduct any applicable depreciation for machinery or buildings. Finally, add the value of any produce used in the home.

The result is net farm operating income - the net farm income generated from the actual operations of the farm. To this, you add gain on sale of assets and deduct loss on sale of assets. You have now calculated net farm income - the true measure of your farm's financial performance.

This financial analysis of your farm is made easy with Manitoba Agriculture's "Farm Financial Planning Package" or the various financial packages available through your ag. lender. A Manitoba Agriculture Information Update, "Measuring Your Financial Progress", provides a detailed explanation of how to analyze your farm finances.

Inventory Taking

Critical to the adjustment of cash income is inventory taking - the actual process of physically counting, estimating and valuing inventory items. An actual assessment of beginning and end of year inventory values is necessary to complete your financial picture.

Certain items in the adjustment process can be readily obtained from existing financial records without requiring "inventory taking". Accrued interest can be determined by multiplying the outstanding balance of a loan by the interest accruing on the loan per day and the number of days the loan is outstanding. Depreciation can be estimated on an overall farm basis for groups of assets. Or, it can be found on an asset basis by multiplying the remaining asset value by its depreciation rate.

Other items, such as purchased feed, can be "easily lost" if not recorded at year end. These items are market livestock, breeding livestock, crops and produce, feed and farm supplies, accounts receivable and accounts payable and should be included in your year end inventory taking.

To assist you in recording these items, Manitoba Agriculture has produced an inventory taking booklet, "Farm Profits Begin With A Clear Financial Picture". The booklet has sufficient space to record quantities and values for each item.

When completing your inventory taking, you should always use the same date - corresponding to your farm's year end, December 31st for most farmers. This allows you to produce financial records which are comparable from year to year - a must for farm financial planning.

Summary

Inventory taking is an essential step to obtaining a clear financial picture of your farm business. All it takes is a little time and effort. Manitoba Agriculture staff or your ag. lender will be glad to assist you to analyze your farm records. It will hel, you make knowledgeable and sound financial decisions from here on in.

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For further information, pick up a copy of these publications from your agricultural office:

- Farm Profits Begin With A Clear Financial Picture
- Measuring Your Financial Progress
- Obtaining A Farm Loan